

Tax Supported
New Issue**State of Hawaii****Rating**General Obligation Bonds AA
(Upgraded from 'AA-' on 2/16/06)**Analysts**John P. Ceffalio
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Director of Finance
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\$350,000,000 General Obligation Bonds of 2006, Series DI, are expected to sell on March 7 via negotiation through a syndicate led by Citigroup. The bonds will be due Oct. 1, 2010–2016 and may be called on or after March 1, 2016.

Security: The bonds are general obligations of the State of Hawaii, with full faith and credit pledged. Debt service on the general obligation bonds represents a first charge on the state's general fund.

■ Outlook

The rating upgrade to 'AA' from 'AA-' is based on the increasing strength of Hawaii's economy, which has led to stellar revenue growth and very large fund balances. Financial operations have been maintained soundly, even under stressful periods, and budgetary procedures are conservative. Hawaii has a highly developed tourism economy, with extensive infrastructure and all-season attraction. While the events of Sept. 11, 2001 had a sudden and severe impact on this airline-dependent state, tourism growth has resumed, and visitation has now exceeded its previous peak. The large military presence continues to be an important factor, and surging employment growth in professional and medical services has added a measure of diversification.

Debt levels are high at 11.6% of personal income, although debt does amortize rapidly and is well secured, with general obligation principal and interest representing a first charge on the general fund. Pension funding levels have fallen below norms.

■ Rating Considerations

Hawaii has an extensive tourism economy, with a broad range of facilities on each of its four major islands. Attractions include a subtropical climate, scenic beauty, Polynesian culture, and a wide variety of hotels with various ancillary facilities such as golf courses, supplemented by the growing presence of second homes and time-shares. Following a period of economic weakness and dampened tax collections in the mid-1990s due to the recession in California and a persistent recession in Japan, visitor arrivals reached a near record in 2000 before a sharp slowdown in 2001 as a result of the recession and especially the events of Sept. 11. For the year, arrivals fell more than 9%, then held flat during 2002 and 2003 with the recession, continued terrorism fears, and the SARS outbreak in Asia all dampening the tourism climate.

The tourism outlook brightened considerably in 2004 and 2005 as the global economy strengthened. Visitor arrivals in Hawaii rose 8% in 2004 and another 7% in 2005, with robust growth from both international and domestic sources, leading to a hotel occupancy rate above 80% for the first time in at least 15 years. This visitor growth, combined with a large military presence and strong growth in the professional and health services sectors, has yielded sterling job and income growth, driven the unemployment rate below 3%, and provided for excellent state revenue growth.

The state, which exhibited its ability to maintain balances through the trials of the last 15 years, has now begun to grow those balances. The largely inclusive general fund's closing balance peaked at \$350 million in fiscal 2001 before falling to just \$117 million at the end of

March 2, 2006

fiscal 2003. After a rebound to a \$185 million balance in fiscal 2004, revenue growth from both the excise and income taxes was extraordinary in fiscal 2005, leading to a sizable \$486 million cash balance. To date, fiscal 2006 has been similar to the prior year, with to-date revenue growth of greater than 12%, and running well ahead of estimates. The state expects balances to grow to \$574 million, or 12% of revenues. The rainy day fund remains paltry at \$55 million, although notably, the governor has proposed a welcomed one-time deposit to double its funding.

Almost all of Hawaii's debt is general obligation, although it includes highway revenue bonds payable from highway taxes. Several categories of general obligation debt are reimbursable obligations, with debt service met from such sources as fees from harbors, airport, parks, university auxiliary revenues, and the hotel tax for convention center bonds. All but the convention center and highway general obligation bonds are considered by Fitch Ratings to be self-supporting and are deducted to reach net tax-supported debt, which is now \$4.8 billion, or \$3,756 per capita and 11.6% of personal income. While these ratios are quite high compared with those for other states, Hawaii is highly centralized, and education, for example, is completely financed at the state level. Just greater than 70% of general obligation bonds are retired in 10 years.

Pension funding has emerged as a concern, with the unfunded actuarial liability now topping \$4 billion. Funding ratios declined to less than 69% on June 30, 2005 from nearly 95% in 2000.

One potentially large and unquantifiable area of exposure involves state lands transferred to the U.S. in 1898 by the Republic of Hawaii and ceded to the state upon its admission to the union. The lands are to be held in public trust, and there continues to be litigation regarding the amount of money in the trust that the Office of Hawaiian Affairs is entitled to receive.

■ Strengths

- Almost all debt is general obligation, with rapid amortization.
- Centralized administration; education is completely a state responsibility.
- Financial balance has been maintained during periods of economic and financial stress.
- Hefty general fund balances.
- Extensive tourist infrastructure.

■ Risks

- Debt is high, and declining pension funding levels have led to a large unfunded liability.
- Rainy day fund levels remain paltry, although a proposal would enlarge the fund.
- Economy still dominated by tourism, prone to broad swings caused by events out of the state's control.
- Geographic location limits diversification efforts.

■ Debt Position

Hawaii's constitution provides for legislative authorization of debt and limits it to the amount (maximum) that can be serviced from 18.5% of a three-year average of general fund revenues, excluding federal grants and moneys received as debt reimbursements. In addition to general obligations, both reimbursable and nonreimbursable, special improvement bonds are allowed as long as the revenue involved is related to the bond purpose (such as highway revenue bonds) and special purpose bonds for such institutions as hospitals or utilities. In the latter case, no state credit is involved, but the centralization of debt management is preserved.

General obligation bonds now account for 93% of gross debt, with the remainder represented by a growing amount of highway revenue bonds and a minor amount of special assessment bonds and lease rental bonds for state office buildings. Since fiscal 2001, highway construction has been met from highway revenue bonds. Within the category of reimbursable bonds, where debt service is met from transfers to the general fund, those for the airport, harbor, university, water, and parking are deducted to

Debt Statistics

(\$000, As of Feb. 1, 2006)

Reimbursable General Obligations	355,158
Nonreimbursable General Obligations	3,744,871
Now Offered	350,000
Total General Obligation Debt	4,450,029
Highway Revenue Bonds	297,605
Special Assessment Bonds	900
Certificates of Participation (State Office Building)	67,505
Gross Tax-Supported Debt	4,816,039
Less: Reimbursable Bonds (Airport, Harbor, University, Parking, and Water)	26,450
Net Tax-Supported Debt	4,789,589

Net Tax-Supported Debt

Per Capita (\$)*	3,756
As % of Personal Income	11.6

Amortization (General Obligation Debt) (%)

Due in Five Years	38
Due in 10 Years	70

*Based on 2005 census estimates.

reach net tax-supported debt even though some aviation fuel taxes are involved. Bonds issued for a convention center, considered reimbursable by the state, are not deducted, as the servicing source, the hotel tax, is considered a state tax source. Amortization of debt is rapid, with more than 70% due in 10 years. Earlier this decade, refundings were structured to provide near-term budget relief, which slowed amortization slightly. Debt is constitutionally required to mature in 20 years, and the first payment installment must be made within five years of issuance.

Net tax-supported debt is currently \$4.8 billion, or \$3,756 per capita and 11.6% of personal income. While these ratios are high compared with those for other states, Hawaii performs functions handled locally elsewhere, and when estimated local debt is included, the ratio to personal income is more in concert with national levels. Hawaii's debt-to-personal income ratio was as high as 19% in 1975.

■ Financial Operations

Hawaii operates with an inclusive general fund, supplemented by the capital projects fund and special

funds, which account for highways, airports, harbors, and other programs. Expenditures are subject to a ceiling, based on a three-year average of personal income growth; spending in recent years has been within the limit. There is no revenue limit, but when the general fund balance exceeds 5% of revenues at the end of each of two successive fiscal years, a refund or tax credit must be provided to taxpayers. Budgeting is biennial, and reporting is on a generally accepted accounting principles (GAAP) basis, as well as a budgetary basis. Six-year planning is in place, and a tax review commission is required every five years. Revenue estimates are prepared by a forecast council and updated quarterly.

The emergency and budget reserve fund was established by 1999 legislation initially from the allocation of 40% of the proceeds from the tobacco settlement (reduced now to 24.5%). Appropriation from the fund requires a two-thirds majority vote of each house of the legislature. With the fund's tobacco settlement allocation being used currently for operations, the balance in the fund has been flat, at about \$55 million at the end of fiscal 2005. The

GAAP General Fund Financial Summary

(\$000, Fiscal Years Ended June 30)

	2002	2003	2004	2005
General Excise Tax	1,641,008	1,771,629	1,893,916	2,139,798
Income Taxes	1,081,723	1,050,688	1,254,341	1,484,664
Total Taxes	3,041,818	3,165,780	3,470,713	4,018,536
Total Revenues	3,242,888	3,414,510	3,709,308	4,198,123
Lower Education	1,239,426	1,324,719	1,363,937	1,434,862
Higher Education	450,891	462,453	459,640	510,194
Welfare	513,656	528,519	565,325	623,599
General Government	369,399	332,332	315,781	384,203
Health	354,626	361,804	368,315	389,984
Total Expenditures	3,214,587	3,308,746	3,363,509	3,653,792
Transfers In and Other Sources	79,252	169,256	30,313	98,600
Transfers Out and Other Uses	(334,244)	(349,105)	(259,843)	(296,458)
Net Surplus/(Deficit)	(226,691)	(74,085)	116,269	346,473
Balance Sheet				
Cash and Investments	341,710	230,523	326,702	631,426
Less: Current Liabilities and Encumbrances	187,446	130,054	160,599	153,027
Current Position	154,264	100,469	166,103	478,399
Taxes Receivable	288,501	283,300	304,900	338,300
Interfund Receivables	104,900	113,600	135,100	131,168
Deferred Revenues	11,500	20,000	7,500	13,800
Total Fund Balance	578,729	502,828	619,097	965,570
As % of Revenues	17.8	14.7	16.7	23.0
Undesignated Fund Balance	311,107	267,418	381,740	715,069
As % of Revenues	9.6	7.8	10.3	17.0

GAAP – Generally accepted accounting principles.

governor has proposed doubling the fund through a one-time deposit from surplus.

The general excise tax is the state's major revenue source, accounting for about one-half of general fund revenues, followed by the personal income tax, at 32%. Unlike many sales taxes, Hawaii's excise tax does tax services, which is a key strength as the economy becomes more dominated by this sector. Education, human services, and debt service are the principal expenditure items. Revenues grew rapidly in the 1980s, and sizable surpluses were achieved and rebates were made several times when the ending surplus exceeded its trigger point. Growth slowed during the early 1990s, and operating deficits shrunk the budgetary balance to \$90 million at the close of 1995, or about 3% of revenues, from \$629 million at the close of fiscal 1989. The remainder of the 1990s was more stable yet still constrained until stronger growth returned in fiscal 2000, lasting until the events of Sept. 11, 2001 caused a sharp and immediate slowdown in the state's economy.

Hawaii closed fiscal 2001 with a healthy \$349 million balance, about 10% of revenues. The state had intended to utilize the balance to fund collective bargaining agreements before the abrupt drop in visitor activity in the fall of 2001 depressed revenue collections, forcing the use of balances for operations. During fiscal 2002, the state projected more than 5% in tax growth; however, estimates were sharply reduced after Sept. 11, 2001 and receipts were ultimately down 3.5% below the prior year's, lowering the closing fund balance to \$215 million. Tax collections for fiscal 2003 fell well short of expectations, growing just 1.8% and driving the fund balance to just \$117 million and only after midyear expenditure cuts were completed. On a GAAP basis, Hawaii ran operating deficits in both fiscal years 2002 and 2003, although it closed fiscal 2003 with a still-healthy fund balance of \$503 million.

For fiscal 2004, revenue growth was initially set at 7.7% and another small operating deficit of \$22 million was forecast, even after expenditure growth was reduced. Following midyear estimate cuts, revenues ultimately came in ahead of forecast, at 8.3% over the prior year's. Individual income tax led the way, up 11.2% over the fiscal 2003 level. The balance increased to \$185 million, or 4.7% of revenues. On a GAAP basis, the state ran a \$116 million operating surplus and ended with a \$619 million total fund balance.

Performance was even better in fiscal 2005, and revenue estimates were increased multiple times before ultimately finishing up 15.5% over fiscal 2004 levels. Excise taxes grew nearly 13%, and the personal income tax was up nearly 17%. The unexpectedly large revenue growth led to an operating surplus of more than \$300 million, with a closing balance of \$486.4 million. On a GAAP basis, the state had a sizable operating surplus of \$346 million in fiscal 2005 and closed with a \$966 million total fund balance, nearly 23% of revenues.

Through January, fiscal 2006 revenues were again unexpectedly strong, with 12.2% growth well ahead of the 8% growth estimate, which had been upwardly revised. The 8% growth estimate was expected to lead to a \$574 million closing balance, or more than 12% of expected revenues.

The governor has proposed using portions of the surplus for an income tax cut. The \$286 million proposal would raise the standard deduction, widen tax brackets, and give a \$100 per person tax credit to households earning less than \$50,000. Additionally, the proposal includes a one-time refund of \$150 per exemption for most residents.

The state has improved tax collections through use of technology and targeted enforcement. Delinquency collections of \$234 million in fiscal 2005 were more than double those of fiscal years 2001 and 2002 and well above the \$156 million in fiscal 2004. The state believes that these collections — a significant contributor to the state's fiscal 2005 operating surplus — will continue to be part of the tax base in future years.

A growing unfunded actuarial pension liability is an increasing concern. The large system — with more than 63,000 active employees and 33,000 retirees — suffered along with the equity markets earlier in the decade, and as of June 30, 2005, the system was 68.6% funded, down from nearly 95% in 2000. The unfunded liability now exceeds \$4 billion, although the state expects this will decline with the next valuation as the four-year smoothing period begins to reduce the effect of the poor equity markets earlier this decade. The state has taken some steps to reduce its other post-employment benefits liability, and the governor has requested funding to begin a full actuarial review of the liability.

Tourism Statistics

(Mil., Years Ended Dec. 31)

	Visitors	% Change	International	Domestic	Hotel Occupancy Rate (%)
2000	6.9	2.9	2.5	4.4	76.0
2001	6.3	(9.3)	2.1	4.2	59.2
2002	6.4	1.3	2.0	4.4	59.8
2003	6.4	0.1	1.8	4.5	72.5
2004	6.9	8.3	2.0	4.9	77.8
2005	7.4	6.8	2.1	5.3	81.0

■ Economic Base

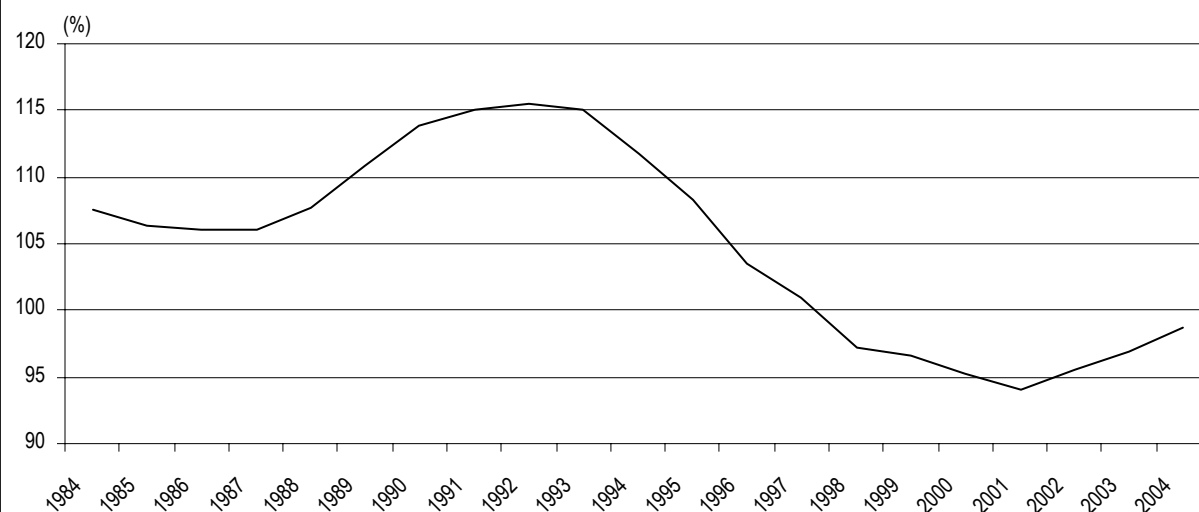
Hawaii consists of four major islands and several other smaller ones. There are only four organized governments, the counties, in addition to the state. The economy rests heavily on well-developed tourism, although there is a significant federal military presence and some remaining agriculture. The population is now approaching 1.3 million, of which about 75% is on Oahu. Population growth of 5.3% since 2000 now equals the national rate after much slower growth during the 1990s. The state, while slightly older than the U.S., has a well-educated population.

Employment is concentrated in leisure, trade, and government, although health and professional services have grown. Employment grew at good rates, in excess of the U.S. rate, through 1992 but thereafter declined slightly but consistently in virtually every year through 1998; the unemployment rate remained well above the U.S. rate. In 1999, employment began to increase but did not recover to the 1992 prior peak until 2000.

While the events of Sept. 11, 2001 had a sharp impact on the state, recovery began to be evidenced rather quickly by the first quarter of 2002, and Hawaii experienced no job losses. Annual employment gains were 0.7% in 2001 and 0.3% in 2002, before strong growth commenced in 2003, with employment rising 1.9%. Growth in 2004 and 2005 was even more robust, with employment up 2.6% in 2004 and December 2005 up 2.8% over the level one year prior, led by growth in professional services (up 4.4%), as well as leisure and education and health services (both up 2.5%). The unemployment rate of just 2.7% indicates a very tight labor market that may constrain future growth. The very robust local real estate market, including second home purchases, also has significantly contributed to economic resurgence, creating some exposure to a market correction.

Personal income has followed much the same pattern, with inferior performance through much of the 1990s. Relative performance was extremely strong in 2002–2004 and through the third quarter of 2005, the

Per Capita Personal Income as % of U.S. Level
(Years Ended Dec. 31)



most recent data available. Per capita personal income has swung wildly compared with U.S. levels. As recently as 1992, Hawaii's per capita personal income was 115.5% of the nation's. The figure then fell every year until 2000, when it reached just 94%, before recovering in each year since to nearly 99% in 2005.

Hawaii developed rapidly following statehood, more than tripling its jobs to 543,000 by 1992 from 177,000 in 1959, posting only one yearly loss over the period. The growth was driven by tourism, as Hawaii's unique culture, natural beauty, and warm climate was ideal for placement of hotels and resorts catering to rapidly growing and affluent markets in Japan and California. By 1991, nearly 7.0 million visitors arrived in Hawaii. However, with the steep recessions in both major markets in the early 1990s, visitation tumbled to only 6.1 million in 1993, and the hotel occupancy rate, as high as 79% in 1989, fell to 72%. Compounding the troubles, the visitor industry recovered very slowly, and visitation only reached the prior peak once during the remainder of the decade; the hotel occupancy rate did not exceed its 1989 peak until 2005.

Tourism made a strong comeback in 2000 and the first half of 2001 and was approaching peak levels before the events of Sept. 11, 2001 abruptly curtailed air travel. Visitation was down more than 9% in 2001, and depressed levels continued until 2004, with contributing factors including fears of terrorism, the SARS outbreak in Asia, and the global recession. Renewed growth began in 2004, and visitation rose 8.3%, followed by another robust year in 2005, when growth was 6.8% and visitation of 7.4 million set an all-time record. Hawaii continues to market to countries beyond Japan, but while growth from other countries — including China — has been strong, Japanese still made up more than 61% of foreign visitors in 2005.

The federal government maintains a large military presence in Hawaii at numerous installations, exercising a large and stabilizing influence on the economy. Total federal expenditures in 2004 were \$12.2 billion, steadily increasing, and nearly 31,000 civilians are employed, in addition to some 53,800 military personnel.

Economic Trends

Nonfarm Employment

(000, Not Seasonally Adjusted)

	HI	% Change	U.S.	% Change	HI	U.S.	HI as % of U.S.
1980	528	—	109,487	—	2.4	5.6	43
1995	533	0.8	117,298	7.1	5.5	5.6	98
1996	531	(0.4)	119,708	2.1	5.9	5.4	109
1997	532	0.2	122,776	2.6	5.8	4.9	118
1998	531	(0.1)	125,930	2.6	5.7	4.5	127
1999	535	0.7	128,993	2.4	5.0	4.2	119
2000	551	3.1	131,785	2.2	4.0	4.0	100
2001	555	0.7	131,826	0.0	4.3	4.7	91
2002	557	0.3	130,341	(1.1)	4.1	5.8	71
2003	568	1.9	129,999	(0.3)	3.9	6.0	65
2004	582	2.6	131,435	1.1	3.3	5.5	60
December 2004	599	—	133,187	—	3.0	5.4	56
December 2005p	615	2.8	135,044	1.4	2.7	4.9	55

Unemployment Rates

(%, Not Seasonally Adjusted Annual Rates)

Personal Income

(Change from Prior Year)

	% Change		HI as % of U.S. Growth
	HI	U.S.	
1995	1.7	5.3	32
1996	0.6	6.0	10
1997	3.0	6.1	49
1998	2.4	7.4	33
1999	2.8	5.1	55
2000	5.5	8.0	69
2001	2.0	3.5	56
2002	3.5	1.8	199
2003	4.8	3.2	151
2004	8.0	6.0	134

Personal Income per Capita

(Change from Prior Year)

	% Change		HI as % of U.S. Growth
	HI	U.S.	
1995	0.9	4.1	22
1996	0.1	4.8	2
1997	2.2	4.8	47
1998	2.1	6.1	35
1999	3.2	3.9	82
2000	5.4	6.8	79
2001	1.1	2.4	46
2002	2.5	0.8	319
2003	3.6	2.2	166
2004	6.8	4.9	138

Components of Personal Income: Earnings

(%)

	HI		% Change	U.S.		% Change
	2002	2004	2002–2004	2002	2004	2002–2004
Construction	7	7	20	6	6	12
Manufacturing	3	2	8	14	13	5
Trade, Transportation, and Utilities	15	15	13	16	16	9
Financial Activities	7	7	24	10	10	15
Professional and Business Services	12	12	19	13	15	10
Education and Health Services	10	10	13	15	11	13
Government and Government Enterprises	32	31	15	16	17	12
Total Nonfarm Earnings	—	—	16	—	—	10

State Population: 1,211,537 (2000 census), 1,275,194 (2005 census estimate)

Population Change: 1990–2000: U.S. 13.1%, Hawaii 5.3%; 2000–2005: U.S. 5.3%, Hawaii 5.3%

Personal Income per Capita 2004p: \$32,606 = 98.7% of U.S., rank 19th

p – Preliminary. Note: Monthly unemployment rates are seasonally adjusted.

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